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Tax aggressiveness and negotiations: A conceptual paper

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Abstract

Negotiation is a pervasive feature of relationships among auditor-clients, buyer-sellers, as well as being a part of tax audits. Various forms of negotiations occur between the taxpayer and the tax authorities but nothing is mentioned in the literatures on the processes and procedures of how both parties arrive at a settlement that is amicable to both parties. This study reviews the literature on how concession timing negotiation strategies adopted by the tax authorities and the tax practitioners' aggressiveness impact negotiation outcomes.

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1. Introduction

Negotiation is defined as “a form of decision making in which two or more parties talk with one another in an effort to resolve their opposing interests” (Pruitt, 1981). Davis and Smith (2003) conducted a study on negotiation and found three important components in negotiation: (i) negotiation is a two-way exchange of information, (ii) each negotiating party evaluates the information from their own perspectives, (iii) the final agreement is reached by mutual selection. They formed a few small groups with outstanding tasks to examine the effects of negotiation. They found that negotiation is an effective tool to solve problems and tasks.

Negotiators may take their position before a negotiation process starts. Negotiation involves an opening offer, opening stance, and initial concession with counteroffers at the beginning of a negotiation. Lewicki, Barry, and

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Saunders (2010) commented that concessions are central to negotiation in order to increase the satisfaction levels of negotiators during the negotiation process. Nevertheless, negotiators are advised to identify the target point of the other party in order to ensure enough room in the bargaining range to make some concessions. Final offers are presented when there are no further concessions for the negotiators to bargain with and the parties involved are expected to accept the message conveyed.

Many researchers have conducted studies on tactics of negotiation, negotiation behaviour, factors such as negotiation process, and judgment bias (Bame-Aldred & Kida, 2007; Bazerman & Chugh, 2005; Steinel, Van Kleef, & Harinck, 2008; Trotman, Wright, & Wright, 2005). These researchers focused on the negotiation between auditor-clients, buyer-seller, and two or multi-party negotiations. However, no negotiation research has been conducted in the area of taxation.

In various countries, various forms of negotiations occur between the taxpayer and the tax authorities. In China, Chan and Lan Mo (2000) found that since the guidelines for staff welfare provision are complicated, taxpayers would negotiate with tax authorities in China if they would like to claim larger expenses when tax rates are high during post tax holiday periods. In the US, Antle and Nalebuff (1991) commented that although the Government benefits from overstatements and incurs losses from understatements, the Internal Revenue Service (IRS) is given a mandate to perform an unbiased audit. If the IRS disputes any of the firm's representations, the IRS traditionally makes a settlement offer before going to tax court. Although these literatures mention the existence of some form of negotiation between taxpayers and tax authorities during the tax audit period, nothing is mentioned of the processes and procedures that these taxpayers and tax authorities undergo to come to a settlement that is amicable to both parties. Thus, no existing literature provides an explanation on how these negotiations take place between tax authorities and their appointed tax agents during the tax audit period.

One of the factors that leads to a more satisfactory negotiation is timing. However, the effect of an aggressive stance by negotiators may reduce the satisfaction levels of the parties involved in the negotiation. Therefore, this study will mainly observe how negotiation strategies in the form of concession timings adopted by the tax authorities and the aggressiveness of tax practitioners (representing their clients who are taxpayers) lead to more satisfactory negotiation outcomes. The focus of this study is on negotiation strategies and their satisfactory outcomes. The appropriate negotiation strategies not only expedite the tax audit process but also avoid any unnecessary cost resulting from tax litigation due to failed negotiations. The next section explains the role of negotiation in tax audit cases in the Malaysian context. This is followed by a review of the literature on negotiation strategies and tax practitioners' aggressiveness.

2. Tax audit and negotiations in Malaysia – institutional background

Negotiation is a pervasive feature of tax audits especially tax field audits and investigations in Malaysia. Figure 1 shows that negotiation in taxation happens during a tax audit period when the tax authorities offer their concessions, subsequent to their tax audit visit (shaded in grey). Taxpayers may negotiate with the tax authorities in the event that their potential tax liabilities are substantial. In normal circumstances, the tax authorities may raise some tax issues subsequent to the tax audit visit, and taxpayers or their representatives who are tax practitioners will respond to these issues with their justification pursuant to the existing tax regulations or preceding case laws, together with the relevant supporting documents (if any) to substantiate their claims. If the tax audit findings subsequent to tax audit visits are conclusive without having taken into consideration any feedback from taxpayers or tax practitioners (i.e. tax negotiation did not take place), it appears that the taxpayers or tax practitioners are considered to be in a weak position. As a result, taxpayers' or tax practitioners' satisfaction levels (e.g. satisfaction of outcome, perceptions of fairness on tax regulations) are low and may affect their tax compliance behaviour. Thus, negotiation is a crucial part of any tax audit as it facilitates the interaction between taxpayers, tax practitioners, and tax authorities. The role of negotiation in tax audits is to align the different motivations of taxpayers or tax practitioners and tax authorities. During the tax audit period, taxpayers and tax practitioners are interested in lowering reported taxable profits while tax authorities would like to ensure that the reported taxable profits of taxpayers are calculated pursuant to the existing tax laws and regulations (Antle & Nalebuff, 1991). Negotiation minimizes the prospect of either the taxpayers or tax authorities resorting to tax litigation to resolve any dissatisfaction towards the audit findings. Hence, there is a need to improve our understanding of negotiation

strategies for the success of a tax audit's negotiation from the point of view of taxpayers as well as their representatives, i.e. tax practitioners.

The outcomes of the negotiations affect the finalization of tax adjustments subsequent to a tax audit. The Inland Revenue Board (IRB) is expected to reduce the number of tax audit cases still in progress in the subsequent year and collect the underreported income from taxpayers. This research is aimed at identifying the appropriate combination of concession strategies that would find an optimum balance between the objective of the IRB and the satisfaction level of taxpayers.

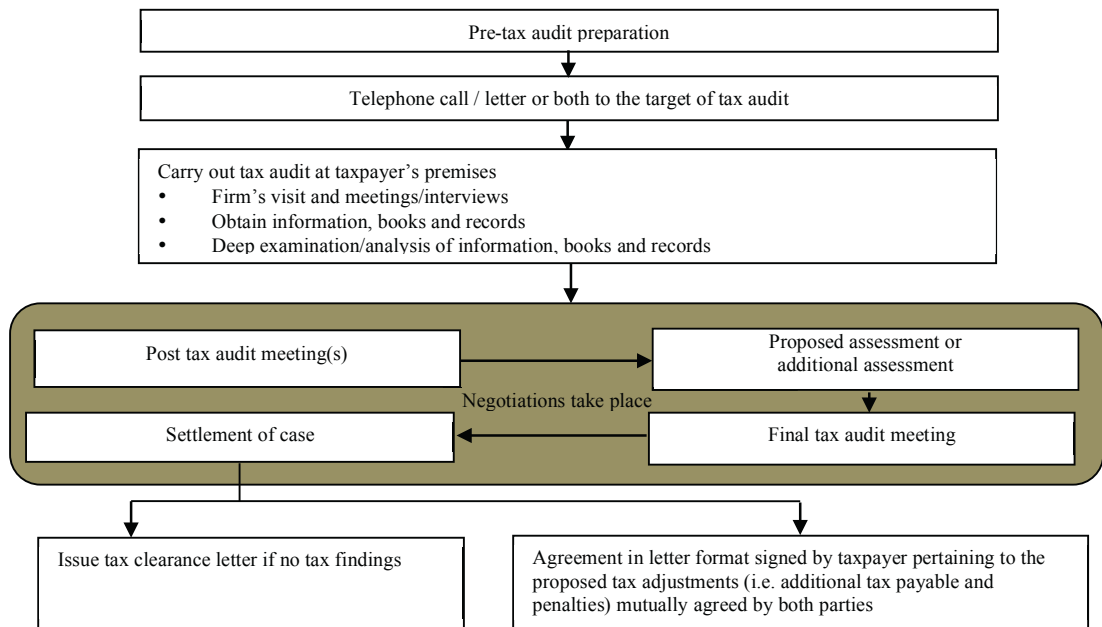


Figure 1: Tax audit in Malaysia

3. Literature review

This section discusses the relevant literature in relation to negotiation strategies. It explains the negotiation strategies and to what extent the level of aggressiveness of tax practitioners influences taxpayers' satisfaction on the audit officers' performance and tax audit outcome.

3.1. Negotiation strategies and satisfaction

Negotiation strategies have many benefits. Bame-Aldred and Kida (2007) conducted an experimental study to identify the types of negotiation tactics that improve the negotiation between auditors and their clients. They designed an audit case to assess the perception of both parties' goals to determine the most effective tactics during the negotiation period. Their result showed that clients are more flexible than auditors. Auditors prefer a more conservative approach than their clients. They also noted that clients were more accurate in estimating the other party's goals and limit.

Gibbins, McCracken, and Salterio (2010) also commented on the negotiation strategies from the auditor's perspective. They distinguished the importance of auditor's negotiation strategies which affect the outcome of auditor-client negotiations. They focused on five strategies, expanding the agenda, problem solving, contending, conceding, and compromising, in their experimental study. Their literatures indicated that negotiators prefer the

first two tactics. However, the auditors who were involved in their study preferred the last three tactics when entering negotiations as they were concerned about preserving the relationship with the other party while obtaining the best outcome for themselves.

Zachariassen (2008) noted the significance of understanding negotiation strategies. He conducted a research to study the impact of different negotiation strategies on the negotiation setting in different buyer-seller relationships. He interviewed a focal firm with a number of suppliers and found that different negotiation strategies should be adopted in different relational settings to improve the negotiations' outcome. Based on his findings, the distributive approach is the most prudent form of negotiation strategy.

Agndal (2007) summarized the business negotiation researches conducted for 1996 to 2005. Other than those researches which focused on negotiation tactics, he found that some researches also studied the negotiation parties, the negotiation process and the negotiation outcome. Those researchers studied the steps in the process which include planning or preparation, bargaining, interaction, and striking a deal. In this empirical study, he commented on the process of communication and the roles of making offers and counteroffers in negotiation. Based on his findings, the negotiation process acted as a predictor of relationship outcomes in an arrangement between buyer-seller.

An experimental study conducted by Trotman et al. (2005) which consisted of three phases, focused on determining the appropriate negotiation strategies which lead to better negotiation processes and result in greater satisfaction, maintain good client relations, communications, and a better understanding of mutual interests. Clearly, the literature confirms that adopting appropriate negotiation strategies are important in ensuring a successful outcome from negotiations.

3.1.1. Concession strategy and timing

Negotiators may use different negotiation strategies during a negotiation process. Spaho (2013) commented that negotiation processes involve different tactics such as face-to-face, persuading, concession, threat, promise, and deceitfulness, which can be applied by using an appropriate negotiation strategy. He further commented that concession is the most important tactic in the negotiation strategy. It helps to create a good atmosphere for solving a problem.

Adair, Weingart, and Brett (2007) commented that offers are an integral part of a negotiation process which communicates a negotiator's position, preferences, and priorities. In their study they observed two types of negotiators, i.e. low context and high context. Low context negotiators use very direct communication styles to convey their preference structure whereas high context negotiators use indirect communication and usually are lacking trust before a strong relationship is formed. They found that for low-context negotiators, the most effective pattern is to exchange information first and make offers later. However, for high-context negotiators, the most effective pattern is to make offers early. When negotiating across high- versus low-context negotiators, negotiators have to make some choices, either use low context, high context, or a mixture. However, their choice will be depending on the culture of the community they live in.

Ros and Sierra (2006) developed a negotiation strategy that combines two tactics, concessions and trade-offs. They found that different negotiation tactics enhance the negotiation process and produce better outcomes (i.e. satisfactory agreements). They involved two agents in their experiments, a buyer and a seller, who negotiated four issues. In their study, the concession tactic is the desired level of offer, decreasing in each step during the negotiation process until both parties achieve a mutually agreed arrangement. However, a trade-off tactic searches all possible offers to achieve the desired level. Thomas, Thomas, Manrodt, and Rutner (2013) supports that the concession tactic helps to achieve a win-win bargaining.

Sanchez, Agoglia, and Hatfield (2007) examined the auditor-client negotiation process by investigating a strategy of concession adopted by auditors during the negotiation of proposed audit adjustments. They conducted an experimental study to investigate the negotiation between both parties. Their experiments involved the auditors' negotiation strategy, the effect of a concession approach during the negotiation process and the effectiveness of negotiation strategies adopted under a concession approach. The result of experiments reflected that a concession approach results in greater client satisfaction and retention as it produces a collaborative environment which helps both parties (i.e. auditors and clients) enter into mutual agreement. They also found under the concession approach,

there was a greater disclosure of waived inconsequential audit differences, resulting in greater client satisfaction and retention. Kersten, Vahidov, and Gimon (2012) commented that negotiators are advised to make concessions in order to move towards an agreement. This will prevent the counterpart from leaving the negotiation and encourages the counterpart to reciprocate. Nevertheless, Horne (2011) found that in certain environments, a lack of trust means that optimal concessions are not made, creating inefficiencies in the negotiation that can reduce the possibility of peace. In his study, he explored ways in which a third party mediator can act as a guarantor that promised concessions will be delivered, thereby reducing inefficiencies and increasing the potential for peace. A few studies (Kersten & Gimon, 2012a; Kersten & Gimon, 2012b; Kersten et al., 2012) observed multi-attribute auctions and multi-issue multi-bilateral negotiations and suggested that different types of concession-making apply to different scenarios in order to benefit both parties. In a multi-attribute negotiation which involves several issues to be considered, one party may not be aware of the other party's preference. However, the study found that when one party's preference is unknown, it wouldn't turn down the negotiation as both parties may give priority to the important issues even though they make losses in other unimportant issues. Similarly, multi-issue negotiation requires a buyer to deal with several sellers. In the case of face-to-face negotiations, the buyer is negotiating sequentially with several sellers. However, electronic negotiation helps the buyer to negotiate simultaneously with several sellers.

Those clients also showed greater satisfaction and intention to retain their auditors when a concession approach is adopted by auditors. Tse, Trotman, and Cheng (2012) extended his negotiation research by studying the impact of negotiation strategies in multi-period negotiations. The focus of his study is the effect of concession timing (i.e. no concession, gradual concession, and delayed concession). He commented that auditors need to consider the impact of concession strategies as it may affect the auditors' negotiation effectiveness in future. The focus of this study is in line with the previous negotiation studies conducted by Tan and Trotman (2007) where gradual or delayed concessions were used, as these strategies are more important in persuading the Chief Financial Officer (CFO) to accept an auditors' proposed audit adjustments. Kwon and Weingart (2004) also conducted an experimental study on the buyer-seller negotiation which focused on the influence of the other party's timing and justifications of concessions. Their results indicated that gradual concessions resulted in greater satisfaction with the negotiation partner than immediate or delayed concessions. Concession-gradual and Concession-end from auditor's perspective are two effective strategies (Tan & Trotman, 2007)

Tse et al. (2012) found the significance of having a better understanding of the negotiation strategies between auditor and clients. The recent changes in the accounting standards and the pressure of regulators on the auditing profession affect the auditors' acceptance level of the audit adjustments. As a result, it also affects the relationship between auditors and their clients who reject them based on any proposed income-reducing audit adjustment to reflect the financial results pursuant to existing accounting standards and regulations. He supported that concession timing strategies adopted by auditors may improve the negotiation outcome and clients' satisfaction. Although he agreed with Tan and Trotman (2007) that gradual and delayed concessions are the most effective strategies in inducing the financial officers to accept larger income-reducing audit adjustments, he expressed his concern that using gradual and delayed concessions may not be a desirable strategy from a regulators' perspective.

3.2. Negotiation strategies and tax preparer's aggressiveness

In a study of negotiation strategies conducted by Ganesan (1993), aggressiveness is treated as one of the negotiation strategies by a negotiator. According to his literature, negotiation strategies are patterns of interaction used by two or multi parties to achieve resolution. His mail survey study on the retail buyers involved three negotiation strategies, i.e. problem-solving, aggressiveness, and compromise. He found that the active aggressive strategy adopted caused a negative relationship and vice-versa, while the use of a passive aggressive strategy may result a positive relationship. Nevertheless, the negotiation strategies research conducted by Ganesan (1993) found the role of aggressiveness in negotiation has a positive impact on the satisfaction with the negotiation outcome.

Spaho (2013) found that if a negotiation strategy does not improve its negotiation outcome, the negotiator may involve an external consultant to solve the problem. The external consultant becomes a mediator on how to solve

the problem. Similarly, in taxation, tax practitioners act as taxpayers' mediators in tax negotiation research. Nichols and Price (2004) found that through a tax practitioners' representation, tax practitioners are able to reduce taxpayers' final tax assessment during an IRS audit. Their study involves a small group of students without tax audit experience but with appropriate guidance from tax professionals to assist a small sample of taxpayers. In another study of Leviner (2012), he found that a key motivator of taxpayers to obtain the services of tax professionals is the growing complexity of tax regulations. Tax practitioners also act as gatekeepers to ensure tax compliance of their clients. The contrasting role of tax practitioners could ensure that they are not overtly aggressive (Bobek & Radtke, 2007; Shafer & Simmons, 2011).

In taxation, aggressive strategies are adopted by tax practitioners under certain circumstances when defending their clients (O'Donnell, Koch, & Boone, 2005). Leviner (2012) commented that taxpayers, whether they are aggressive or passive, are likely to agree with their tax agents' (tax practitioners) advice. In his empirical research, he found that taxpayers relied heavily on tax practitioners who could possibly be a source for aggressive tax planning. It is only when tax practitioners are able to reduce the aggressiveness of their recommendations that they are able to prevent noncompliance by taxpayers.

There is no literature that discusses on how tax aggressiveness of tax practitioners could have an impact on tax audit negotiations. However, O'Donnell et al. (2005) provides some insights into some of the influences in the tax audit environment on tax practitioner's aggressiveness. O'Donnell et al. (2005) conducted two experiments on experienced tax professionals who provided recommendations to their clients and examined the interaction between task complexity with procedural knowledge and outcome expectations. They found that tax professionals are more aggressive if the tax position of their client can be defended during an IRS audit. However, if the level of complexity increases, tax professionals with greater procedural knowledge should be more conservative (i.e. less aggressive) as uncertainty increases. Tax complexity may influence the aggressiveness of tax practitioners in tax audit negotiations.

4. Conclusion

The discussion above outlines two key variables in tax negotiation: concession strategy and tax practitioners' aggressiveness. To summarize, this study contributes to the existing research on tax authority-tax practitioner negotiations by observing the interaction of concession strategy and tax aggressiveness. It permits a better understanding of the consequences of concession timing negotiation strategies adopted by the tax authorities, and the aggressiveness strategies used by tax practitioners. If the tax authorities and tax practitioners apply the appropriate negotiation strategies in the tax audit's negotiation process, voluntary tax compliance behaviour of taxpayers through their tax practitioners will improve. Tax practitioners may use less aggressive tactics to mitigate their tax payable from tax practitioners.

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